

Ohr, Renate

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Renate Ohr*

Exchange-rate Strategies in Developing Countries

Exchange-rate strategies may be used to pursue the most varied objectives as instruments of development policy or of structural adjustment. The following article will examine the advantages and disadvantages of a number of exchange-rate policy options.

The problems faced by developing countries today are many and varied: high balance-of-payments deficits, deterioration in the terms of trade and thus in real export earnings, rural exodus and destitution of the urban population, declining self-sufficiency in foodstuffs, unemployment and inflation. The International Monetary Fund¹ and the World Bank² are backing adjustment programmes intended to improve the balance of payments, to make better use of productive potential, to increase economic growth and to combat inflation. These programmes not only pay close attention to stabilizing macroeconomic aggregates (national income, the inflation rate, the unemployment rate), but also to eliminating structural imbalances.

Structural problems consist, for example, of inadequate infrastructure, insufficiently developed markets, a rudimentary industrial sector, and institutional problems in the public and private sectors. One major aspect of structural imbalances in many developing countries is that the agricultural sector is discriminated against to some extent in favour of the commercial and especially the industrial sectors (urban bias).³

Points at which influence is brought to bear on the agricultural sector include the producer prices paid for agricultural output, the prices paid for foodstuffs by consumers, input prices in the agricultural sector, the level of productivity in the sector, and the provision of food to low-income groups in the population. However, agriculture is not only protected or discriminated against solely by measures specific to the sector itself, but also by other economic policy decisions taken, for example, in the fields of industrial, monetary or fiscal policy, or also of exchange-rate policy. Overvalued currencies, in particular, may lie at the root of discrimination against agriculture in developing countries.⁴ Then again, exchange-rate problems are not only manifested in inappropriate exchange rates (over-

undervaluation), but may also arise from dual or multiple exchange rates, or else from pronounced exchange-rate fluctuations. On the other hand, the extent of the influence of exchange rates on the allocation of resources between various sectors of an economy can also mean that exchange-rate policy is an important instrument of structural adjustment. Against this background, the advantages and disadvantages of a number of exchange-rate policy options for developing countries will be examined below.

Options for a Developing Country

Since the collapse of the international monetary system based on fixed exchange rates in 1973, the developing countries, too, have a wide variety of alternatives available in their exchange-rate policies:

- A free exchange rate, floating either without any interference or on a managed basis.
- A tied exchange rate in which the currency is pegged to another single currency or to a basket of currencies.
- Limited flexibility in the form of a crawling peg.
- A fixed exchange rate within a group of economies maintaining flexible exchange rates with third countries (group floating).

¹ Cf. IMF: Theoretical Aspects of the Design of Fund-Supported Adjustment Programs, Occasional Paper No. 55, Washington, D.C., 1987.

² Cf. World Bank: Adjustment Lending. An Evaluation of Ten Years of Experience, Policy and Research Series No. 1, Washington, D.C., 1988.

³ Cf. H.-B. Schäfer: Niedrigpreispolitik für Agrarprodukte aus entwicklungstheoretischer Sicht, in: A. Woll, K. Glaubitt, H.-B. Schäfer (eds.): Nationale Entwicklung und internationale Zusammenarbeit, Berlin 1983, pp. 42-51.

⁴ Cf. A. O. Krueger, M. Schiff, A. Valdés: Agricultural Incentives in Developing Countries: Measuring the Effect of Sectoral and Economy-wide Policy: The World Bank Economic Review, Vol. 2, 1988, pp. 255-271.

* University of Hohenheim, Stuttgart, Germany.

- Dual foreign exchange markets (with separate markets for goods and capital transactions).
- Multiple exchange rates with different exchange rates (fixed or flexible) for different types of transaction.

Since 1973, then, it is no longer possible to maintain generally fixed exchange rates; the options remaining are free floating or else some form or other of pegged exchange rate, which nevertheless will always involve exchange-rate fluctuations relative to all other currencies which are not pegged to the same currency or basket of currencies.⁵ If a freely floating rate is not felt to be desirable, the key foreign-exchange policy decision a developing country's government needs to take in today's world is to choose the "right peg" for its currency.

During the first 17 years since the abandonment of the fixed exchange-rate system, the developing countries have shown the following patterns of behaviour in pursuit of their foreign exchange policies:⁶

- A declining trend is evident in rates pegged to single currencies. The most obvious such development has been the abandonment of the practice of pegging to the pound sterling and a reduction in the amount of pegging to the dollar, while pegging to the French franc has proved remarkably stable.
- In contrast to the above, much greater use is now being made of pegging to a basket of currencies. There is also an increasing tendency to use baskets which the countries have assembled for themselves and which do greater justice to their trading relations than would pegging to IMF Special Drawing Rights.
- Dual foreign exchange markets and multiple exchange rates have been used to an increasing extent.
- The difficulties involved in choosing the right exchange-rate system are evident from the frequent changes of system which have been carried out. Even if a currency is not officially pegged to another, a close linking to certain currencies is often practised in reality via a high level of intervention on the foreign exchange markets.
- The exchange-rate policy options available to developing countries are often restricted because of the nature of their foreign exchange markets. Currency convertibility, especially where international capital movements are concerned, is frequently strictly limited. Furthermore, most such economies do not yet have forward exchange markets which could provide those engaging in foreign trade with an opportunity to hedge their currency risks in situations with strongly fluctuating exchange rates.

As a general observation, the risks of flexible exchange rates are felt to be higher in developing countries than they are in industrial countries, as they can have greater inhibiting effects on trading sectors if the countries concerned do not have forward markets or any other solid means available of protecting themselves against financial risk. In addition, the relatively low volumes in their financial and capital markets mean that exogenous disruptions can generate relatively substantial exchange-rate fluctuations which – because export and import prices are dictated by the world markets in foreign currency terms – can lead to correspondingly large fluctuations in profits.⁷

By making greater use of pegged exchange rates, the developing countries therefore mainly hope that they will be less exposed to disruptive influences on their objectives of stabilizing employment, real incomes and the price level. Over and above this, dual exchange markets are intended to combine the advantages of different exchange-rate systems: on the one hand, flexible exchange rates for financial transactions are intended to prevent foreign-exchange outflows on the capital account by obviating the need for intervention. Meanwhile, regulated exchange rates governing trade flows are designed to eliminate exchange risks and hence to stabilize export earnings and import expenditure. Finally, multiple exchange rates are often used in an attempt to give specific encouragement to certain sectors of the economy.

Objectives of Exchange-rate Policy

As an instrument of development policy and for aiding structural adjustment, exchange-rate strategies can involve a wide variety of subordinate objectives. What they have in common is that all of them represent attempts to use a suitable foreign exchange policy concept to minimize the negative effects on the country's own major macroeconomic objectives caused by exogenous shocks, whether real or monetary. Efforts to achieve macroeconomic stability usually concentrate on the three fields of external equilibrium, domestic equilibrium and microeconomic efficiency, i.e. efficient resource allocation.⁸ Intermediate goals which exchange-rate policy is intended to achieve may include improving the

⁵ Cf. D. Bender: Wechselkursbindung in Entwicklungsländern: Eine optimale Anpassungsstrategie an flexible Wechselkurse?, in: Kredit und Kapital, 1985, pp. 320-345.

⁶ Cf. IMF: Annual Report, various years, and IMF: Exchange Arrangements and Exchange Restrictions. Annual Report, Washington, D.C., 1989, pp. 568 ff.

⁷ Cf. P. Wickham: The Choice of Exchange Rate Regime in Developing Countries, in: IMF Staff Papers, Vol. 32, 1985, p. 278.

⁸ Cf. P. Collier and V. Joshi: Exchange Rate Policy in Developing Countries, in: Oxford Review of Economic Policy, Vol. 5, 1989, p. 95.

balance of trade and the balance of payments improving the terms of trade and hence also real income, raising the overall levels of production and employment, stabilizing the price level, or stabilizing the relative prices between internationally traded goods and domestically traded goods in order to improve resource allocation.⁹

The optimum exchange-rate system for the developing country concerned is thus whichever one can most effectively protect it against such exogenous disruptions which can detrimentally affect the intermediate goals we have described. The problem is, though, that any one exchange-rate strategy is not generally capable of supporting all the objectives one might like to pursue, and indeed that a strategy which can protect a developing country from all the effects of pronounced exchange-rate fluctuations between its trading partners is practically non-existent.

Floating Exchange Rate

A system of flexible exchange rates is widely regarded as being especially well suited to absorbing monetary shocks, whereas pegged exchange rates are generally called for when it comes to coping with shocks in the real economy.¹⁰ Yet most developing countries still even today lack the capacious financial markets and the accompanying institutional conditions which are necessary for efficient foreign exchange policy. Furthermore, as a result of the largely underdeveloped financial markets, a high degree of restriction is usually placed on capital movements, which means that the institutional preconditions for a freely floating exchange rate are not fulfilled.¹¹

The problem in this regard is that when an exchange rate is determined solely by the supply and demand for foreign exchange generated by trading transactions there is a danger, given the lags in any response from the goods markets, that the foreign exchange market will be unstable.¹² If, for example, an exogenous shock occurs

which causes a depreciation of the currency, and if short-term price elasticities in foreign trade are low (i.e., if the Marshall-Lerner condition is not fulfilled) there will be a deterioration in the current account (because of the J-curve effect) which will trigger a further depreciation. The only way in which stability can be ensured on the foreign exchange market is then if stabilizing capital movements occur, creating a surplus on the capital account to balance out the deficit on current account. If the volume of the national capital markets is too low, if there are institutional restrictions on international capital flows, or if there is a tendency towards capital flight, these stabilizing capital flows cannot be triggered, and a freely floating exchange rate could therefore be subject to exploding fluctuations. That in turn would severely distort the optimum allocation of resources.

Even if such destabilizing fluctuations in the exchange rate do not occur, the advantage of an always balanced foreign exchange account which the floating rate brings, preventing the depletion of currency reserves, has to be weighed against the disadvantage of the risk of a major depreciation of the domestic currency. Such a large-scale depreciation may itself generate undesired effects on domestic inflation rates, and may again trigger off capital flight.

It is only therefore a relatively small number of developing countries which do operate with a freely floating exchange rate; some operate a system of managed floating in which the monetary authorities occasionally intervene on the foreign exchange markets in order to steer the exchange rate in a desired direction, though without aiming at any fixed parity target. However, a more commonly used approach is some form of pegged currency, in which case one needs to distinguish between pegging to a single currency and pegging to a basket of currencies.

Pegging to a Single Currency

The chief problem faced by many developing countries is that there may be considerable differences between the currency structures of their export and import flows. Most raw materials and agricultural products, which frequently make up the bulk of countries' exports, are paid for in dollars. In order to keep export earnings stable in the domestic currency, pegging to the dollar would therefore appear a sensible course to take.¹³ On the other hand, developing countries usually buy in their imports from several different industrial countries as well as from other developing countries (the latter applies especially to raw materials and agricultural items which they do not produce themselves). Although the dollar also plays a quite significant part in this area, as in the case of imports from

⁹ Cf. D. Bender, *op. cit.*, p. 334.

¹⁰ Cf. L. Lipschitz: Exchange Rate Policy for Developing Countries: Some Simple Arguments for Intervention, in: IMF Staff Papers, Vol. 25, 1978, pp. 650 ff.; J. Frenkel and J. Aizenman: Aspects of the Optimal Management of Exchange Rates, in: M. Conolly (ed.): The International Monetary System: Choices for the Future, New York 1982, pp. 19 ff.

¹¹ Cf. W. Branson and L. Katseli-Papaefstraton: Exchange Rate Policy in Developing Countries, in: S. Grossman and E. Lindberg (eds.): The World Economic Order: Past and Prospects, New York 1981, pp. 391-419.

¹² Cf. R. Ohr: Wechselkursserwartungen und Stabilität des Devisenmarktes, in: Jahrbücher für Nationalökonomie und Statistik, Vol. 200, 1985, pp. 289 ff.

¹³ Cf. D. Bender, *op. cit.*, p. 343.

NICs such as Taiwan, Hong Kong, Singapore and South Korea, there are nevertheless cases in which countries maintain equally wide-ranging trading relationships with other currency areas. In such cases, a sensible way of making import expenditure less susceptible to exchange-rate fluctuations would be to peg the domestic currency to a basket of other currencies which fairly reflected the country's external trade links.

The situation poses problems, therefore, if different currencies all play a part in a country's foreign trade and if their values vary markedly in relation to one another, particularly if they fluctuate strongly vis-à-vis the dollar. If the latter is true, pegging to the dollar alone will protect the stability of export earnings, but will lead to exchange rate induced fluctuations in import expenditure, with concomitant effects on consumer prices and real wage levels. On the other hand, pegging to a basket of currencies weighted according to the relative share of imports coming from the different currency areas would render import expenditure relatively insusceptible to exchange rate movements, but would cause export earnings to vary if any pronounced shifts between the dollar and the other currencies in the basket were to occur.

However, yet another consideration which arises is that the range of goods imported is often not confined to raw materials or agricultural produce from other developing countries together with manufactured consumer goods from industrial countries, but may well also include fertilizers, seed and agricultural machinery, which are all important on the cost side for the agricultural sector. If the exchange rates with those currencies which are needed

for such items are stabilized (by assembling the basket of currencies accordingly), this again can establish favourable conditions for stable agricultural production and hence improve export prospects. Under these circumstances another disadvantage of pegging to the dollar becomes apparent, unless the inputs in question are imported from the dollar area.

As a general point, then, where the foreign trade of the country concerned is regionally highly diversified, pegging to a single currency implies the danger of substantial fluctuations in the effective exchange rate.¹⁴ Yet, against that, whatever basket a country chooses to peg its own currency to, this will entail a large number of different bilateral exchange-rate fluctuations. It is, of course, precisely such bilateral changes of parity which individual foreign traders would like to eliminate in order to free themselves from exchange risk. The question which therefore arises is whether bilateral exchange-rate fluctuations are lower on the whole if a country adopts a system of pegging to a basket of currencies or if it pegs to a single foreign currency.¹⁵

Matters are simplified somewhat if both exports and imports are largely conducted with just one other country; the decision on how to peg the currency then becomes relatively straightforward. This is the situation, for example, in the Franc Zone in West Africa. It is interesting to note the relatively high level of stability of this currency

¹⁴ Cf. B. Schneeberger: Wirtschaftspolitische Implikationen alternativer Wechselkursregelungen in Entwicklungsländern, Grösch 1989, p. 49.

¹⁵ Cf. P. Wickham, *op. cit.*, p. 277.

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**Bernadette
Smyrek-Ouertani**

**DAS LÄNDLICHE GENOSSENSCHAFTS-
WESEN IN POLEN**

Von der polnischen Teilung bis zur Gegenwart

The beginnings of peasant self-help organisations in Poland were characterised by the political situation in which Poland found itself in the 19th century. A Polish state had not existed since 1795. Different legal, economic and social conditions therefore prevailed in the areas annexed by Austria, Prussia and Russia. This study describes the development of peasant self-help in Poland. The various types of self-help are first examined historically and then in the form they take today. (Only available in German.)

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zone¹⁶ and of the inflation rates in its individual member countries. The African developing countries in the Franc Zone conduct the bulk of their foreign trade with France itself. At the same time, the Banque de France puts up its own currency reserves to guarantee the stability of the exchange rates. The other side of the coin is that the countries which belong to the Franc Zone have all surrendered their monetary sovereignty to a joint monetary institution.¹⁷ Another benefit which these countries¹⁸ enjoy is that, in view of the relatively stable exchange rates within the European Monetary System they have access, via the Lomé Convention, to an additional large export market with largely constant exchange rates. On the other hand, there is a tendency for individual countries within the zone to have overvalued currencies, especially vis-à-vis their West African neighbours which do not belong to the Franc Zone (Nigeria, Ghana). These countries have been able to achieve competitive advantages over the Franc Zone countries in recent years by depreciations of their currencies in both nominal and real terms.

The following additional criteria are relevant when assessing the effects of pegging the exchange rate on the economy as a whole:

- Are agricultural and raw materials prices within the country coupled to the export prices of the goods concerned, or does market intervention make them move independently?
- Is the bulk of people's income (including that of the urban population) spent on foodstuffs, or do the prices of imported consumer goods also show through clearly in the overall level of consumer prices?
- Does agricultural production depend on imported inputs, and if so, in what currency are they paid for?
- How are the currencies of those countries pegged which are the most important competitors on third markets?

- Which currencies play the largest part in the country's exports and imports of capital?

Pegging to a Basket of Currencies

It is sensible to be pegged to a basket of currencies if countries have relatively diversified regional structures of foreign trade, implying a dependence on a variety of currencies. The most efficient means of achieving the objective of minimizing external disruptions due to exchange-rate fluctuations is to choose an individual basket of currencies; the only situation in which a standardized SDR basket could be judged just as positively would be if the regional structure of a developing country's foreign trade corresponded closely to the currency composition of the SDR. There are, however, a number of other reasons which would favour SDR-pegging.

The first such advantage is that it is a uniform approach which is easy to administer, as the value of Special Drawing Rights is calculated by the IMF on a daily basis. If a large number of developing countries were to adopt SDR-pegging, that would also mean that they would all have fixed exchange rates with each other. That is a good thing as far as coordinating cooperation between developing countries and intensifying South-South trading relations is concerned.¹⁹

As in the case of any other currency-pegging arrangement, SDR-pegging calls for a certain degree of international liquidity to enable central banks to intervene on the foreign exchange markets in order to maintain the desired currency constellation. That liquidity could be created by issuing more SDRs and making them available to the developing countries. This indeed would also be one argument for improving the SDR facilities available to those countries. If more developing countries used them as their basis for currency pegging, it would also help institutionalize SDRs, perhaps via a world trading order in which raw materials prices were tied to them and accounts were settled not in dollars, but in Special Drawing Rights.

The countries that desire to peg their exchange rates are especially those with a high import ratio, in which the exporting sector (usually the agricultural sector) plays a large part in the economy and in which there is a low degree of diversification. Nevertheless, whatever form of pegging is adopted can also produce negative side-effects for the country concerned if this firmly establishes exchange-rate structures which no longer reflect developments in the real economy. The advantage of a certain degree of stability in the currency's external value is then more than cancelled out by the disadvantages of a

¹⁶ Cf. D. Brodsky and G. Sampson: *The Sources of Exchange Rate Instability in Developing Countries: Dollar, French Franc and SDR Pegging Countries*, in: *Weltwirtschaftliches Archiv*, Vol. 200, 1984, pp. 133-154.

¹⁷ That means that the underlying exchange-rate policy is closely linked to a stabilizing budgetary policy, as the Franc Zone countries are not in a position to finance their national budget deficits by increasing their domestic money supply. Cf. P. Collier and V. Joshi, *op. cit.*, p. 101.

¹⁸ Benin, Burkina Faso, Cameroon, Central African Republic, Chad, Comoros, Congo, Equatorial Guinea, Gabon, Ivory Coast, Mali, Niger, Senegal and Togo.

¹⁹ Cf. H.-P. Nissen and K. Behling: *Auswirkungen des Systems flexibler Wechselkurse auf die Entwicklungsländer*, Federal Ministry of Economic Cooperation Research Report, Vol. 6, Munich 1981, pp. 30 f.

falsely valued exchange rate. Before a country gets into a situation where the currency is falsely valued for a relatively long period, it is better to make the transition to a more flexible exchange-rate policy. This is especially so if the country's inflation rate is relatively high. If there are large discrepancies between the developing country's own inflation rate and those of its trading partners, the exchange rates ought at least to be adjusted to reflect the altered purchasing-power ratios.

One technique which is available for such situations is the "crawling peg", in which exchange rates are adjusted on a discretionary basis but nevertheless continually, to reflect international differences in inflation rates, but in which any further exchange-rate fluctuations are prevented by means of market intervention. However, even this approach to exchange-rate management which stabilizes real exchange rates generally does not automatically balance the current account, especially if the price elasticities of traded goods and services are low; nor indeed, especially if large movements of capital occur, does it necessarily produce an overall balance-of-payments equilibrium.²⁰

Dual Exchange Markets

Operating with a dual exchange market is an exchange-rate policy which is particularly characteristic of developing countries which have large balance-of-payments deficits. The dual system usually involves one official, regulated foreign exchange market in which parities are fixed together with a parallel, free market with flexible exchange rates. The key feature of such a strategy is that current account transactions are normally supposed to be conducted on the official market, whereas capital movements are to take place exclusively on the unregulated market.

This type of separation represents an attempt to shield the domestic economy from destabilizing international capital movements without directly restricting capital flows.²¹ Dual exchange markets are not only aimed at screening off the economy from large-scale fluctuations in capital movements, but especially also to isolate it from the destabilizing effects of the excessive capital outflows which are characteristic of countries with a lack of domestic monetary stability. If they operated with a fixed exchange rate, their foreign currency reserves would be undermined by massive outward capital flows, whereas in a system of generally flexible exchange rates, the major depreciation of the currency likely to occur would make imports more expensive and decrease real incomes. That would add further fuel to domestic inflation, and thus be an even greater spur to capital outflows.

How far it will prove possible to screen off, by means of dual exchange markets, the domestic financial and goods markets from the effects of international capital movements depends, for one thing, on whether currency transactions on the regulated market are determined by trade flows alone and, for another, on whether all commercial transactions are settled on the regulated market. There are a few developing countries which reserve the regulated foreign exchange market chiefly for essential imports and for traditional exports, while some foreign trade is settled on the free foreign exchange market alongside the capital flows. In these cases, both the official and the free exchange rates exert their influences on the domestic price level. Discrepancies between the official and free exchange rates may then lead to shifts in the pattern of production within the domestic economy.

As a general rule, developing countries' currencies tend to have a much lower value on the free foreign exchange market than on its official counterpart, meaning that the production of those export goods which earn foreign exchange on the free market is likely to be stepped up, possibly at the expense of traditional export commodities. On the import side, however, free foreign exchange market goods are likely to be substituted by goods which are assigned to the official exchange market, in which the country's own currency has a higher value. Under such circumstances, the foreign currency reserves will be undermined by net capital outflows because the currency depreciation in the free market leads to a trade deficit in the regulated market.²² Besides, the separation of foreign exchange markets is undermined if exchange-rate variations in the free market lead to concealed net capital flows that are settled within the scope of the payments flows resulting from foreign trade.²³ Hence there is a need for efficient administrative controls to ensure that a proper separation is maintained between the different kinds of transactions and to prevent traded goods from being wrongly invoiced or falsely declared.

Multiple Exchange Rates

The regulated foreign exchange markets are frequently still further subdivided by setting different exchange rates for different trade transactions and currencies. In this way

²⁰ Cf. P. Wickham, *op. cit.*, p. 273.

²¹ Cf. R. Dornbusch: *Special Exchange Rates for Capital Account Transactions*, in: R. Dornbusch (ed.): *Exchange Rates and Inflation*, Cambridge 1988, pp. 179 f.

²² Cf. R. Dornbusch, *op. cit.*, pp. 191 f.

²³ Cf. A. Lanyi: *Separate Exchange Markets for Capital and Current Transactions*, in: *IMF Staff Papers*, Vol. 22, 1975, p. 719.

developing countries are trying to improve their balance-of-payments situation via the current account. This functional segmentation by means of multiple exchange rates mostly separates exported from imported goods or else discriminates against the country's traditional products in favour of those from new growth industries.²⁴ Thus, for instance, a higher exchange rate is set for exports than for imports. In addition, multiple exchange rates for different export products are managed so that foreign exchange earnings from agricultural exports (the traditional export commodities) are discriminated against relative to those originating in the industrial sector.

The system of preferences manifested in the way exchange rates are set will reflect the development strategy of the country concerned. Countries with a major dependence on imported industrial goods have a different kind of exchange-rate structure from others which are aiming at import substitution and protection of the domestic economy from technology imports. Multiple exchange rates are thus largely identical in their effects to the selective taxation or subsidizing of certain goods.²⁵

Nevertheless, the use of multiple exchange rates is more than just a trading strategy, for developing countries which use them are also attempting to combat their monetary balance-of-payments problems, namely the constant excess supply of their own currencies on the foreign exchange markets. What such countries are trying to do is to use the multiple exchange rates to partially eliminate the overvaluation of their currency as it affects the trading sector, but without being sucked into an overall spiral of depreciation. The intention is to confine any excessive depreciation to the free foreign exchange market so that the domestic markets, as explained earlier, are delinked from its effects.

In reality, however, the monetary objectives associated with this exchange-rate strategy have only a limited chance of succeeding. Capital outflows, of all things, will not be reduced by separating the foreign exchange markets as long as domestic inflation continues to generate the expectation of further depreciation. Under such circumstances, the policy of separating the markets is unlikely to succeed either in stabilizing the trade balance or in eliminating the deficit on the capital account. If anything, the strategy tends more to destabilize the

situation, as the spread between the official and the free exchange rates is visible, and thus directly reflects the overvaluation of the country's currency on the official market. If participants in the economy expect the official parities to tend to follow the rates at which the currency is being traded on the free market, any depreciation in the free exchange rate generates expectations of a devaluation in the official rate. The expected devaluation in the official exchange rate is then anticipated in the domestic price level, and that in turn triggers off more capital outflows. Thus the evident discrepancies between rates on the different foreign exchange markets will lead to a further widening of the gap between them, and to increasing instability in the balance of payments.²⁶

As it is a fundamental precondition for stabilizing the capital account, monetary stabilization in the domestic economy is also therefore the only basis on which a successful trade policy can be built in developing countries using multiple exchange rates and dual exchange markets.

Conclusion

The optimum approach to exchange-rate policy will be different from one country to another. The decision as to which policy to pursue should, however, at all events be influenced by the following factors:

- the structure of the domestic financial sector, including the money and foreign exchange markets,
- the currency structure of the country's international trading relations and the price elasticities involved,
- the structure of the country's international credit relationships and of its currency reserves,
- the nature of the economic shocks which may occur.

Naturally, exchange-rate policy cannot in itself bring about overall economic stability or optimum structural adjustment. Nevertheless, in the right kind of circumstances it can contribute towards stabilizing export earnings and/or import expenditure, and thus lend support to a more favourable development of the economy in both sectoral and global terms. As far as the monetary problems of developing countries are concerned, a policy of domestic price stabilization must be implemented in addition to appropriate exchange-rate policies if capital flight is to be contained and a vicious spiral of inflation and devaluation is to be avoided. Monetary stability is thus an essential precondition for the strategic use of exchange-rate policy and it is only by combining the two that the foundations for a balanced process of economic development can be laid.

²⁴ Cf. J. S. Lizondo: Unifying Multiple Exchange Rates, in: Finance & Development, No. 4, 1985, pp. 23 f.

²⁵ Cf. S. Collins: Multiple Exchange Rates, Capital Controls and Commercial Policy, in: R. Dornbusch and L. Hellmers (eds.): The Open Economy, New York 1988, p. 132.

²⁶ Cf. J. M. Fleming: Dual Exchange Markets and Other Remedies for Disruptive Capital Flows, in: IMF Staff Papers, Vol. 21, 1974, p. 13; R. Dornbusch, op. cit., p. 197.